DOW THEORY LETTERS INC.

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36 Letters per Year — $125 Annually

Registered with the Securities Exchange Commission

July 9, 1976 — Letter 669

June 25, DJIA 999.84; PTI 604; A-D Ratio -23.18
July 2, DJIA 999.84; PTI 620; A-D Ratio -22.77

THE MARKET REFLECTS: There's a drought blowing across the face of the globe. As a result, commodity prices are going up, and food prices are going up. And people are feeling the big squeeze, the loss of purchasing power as prices in general push up while savings and wages are worth less. The net result, I believe, is a conservatism on the part of the consumer. He's trying to "cool it," and he's thinking twice about buying big ticket items. Meanwhile, liquidity is building up while sales volume lags. The rising prices are destructive; the rising liquidity is constructive.

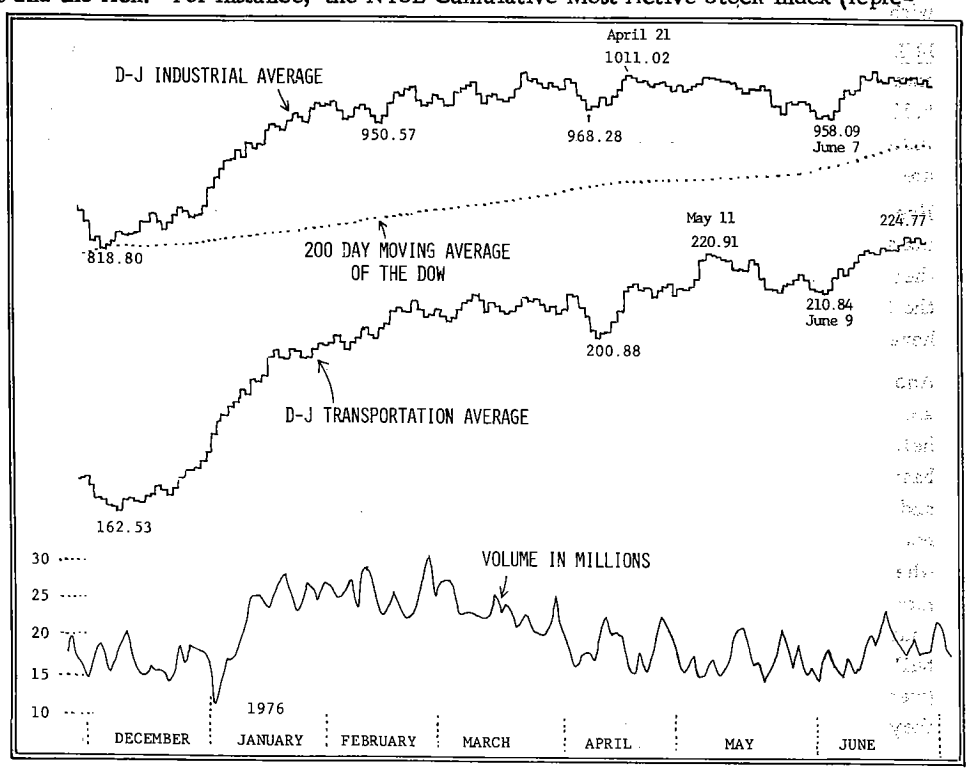
This is the essence of stagnant inflation or "stagflation" as it has been called. The rising prices are inflationary, but the slowdown in sales is deflationary. All of which explains why interest rates are still modest and why we could be in for a major and continuing bull market in bonds. "After all," mulls the bond buyers, "why should I sweat it out with a common stock during a period of stagflation when I can buy a good bond that pays me 9.5% interest?" It's a tough argument to demolish.

One way informed money is attempting to keep ahead of stagflation is via diversified holdings. And this too breeds problems. Speculators have driven land prices up and up. And today those prices are up to levels where new buyers cannot produce profits. Houses are now priced out of the reach of the average buyer. Prices of art objects, coins, stamps, Americana, etc., have been going steadily higher. Everyone is trying to stay ahead of the big squeeze, the rising cost of just living—and it's hard.

Who is the big aqueeze affecting most? Basically, it is affecting the poor and the lower middle class. The upper middle class with superior incomes are still doing all right, and the rich are doing well, since the dollar value of their holdings (whatever those holdings might be) are rising. But it's not a healthy situation, and everyone senses it. We all know that if you buy a house for $60,000 (which costs you $6,000 to carry), and if you can only rent that house for $3,500, then you don't have an investment, you have a piece of property which you're speculating with. In effect, you're betting that there will be a buyer for that house in 1978 for $75,000 or maybe in 1980 for $120,000.

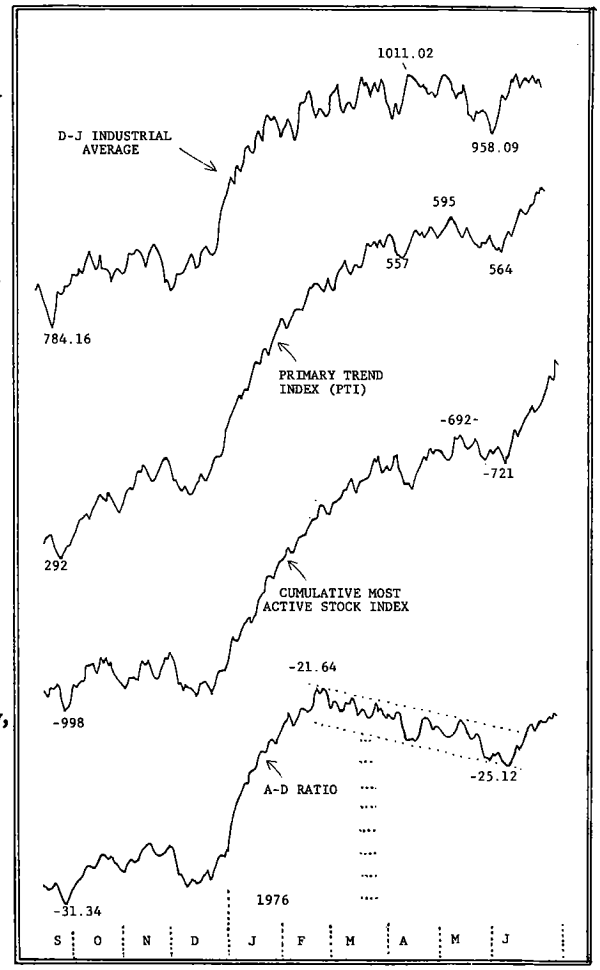
This is the same kind of thinking which sunk the growth stocks a few years ago. People who bought the growth stocks (which were yielding 1% or less) told themselves that the "built-in growth" would take care of the low yield. And the theory worked beautifully, until the growth slowed down or stopped in 1973-74. Then, Wall Street began to realize that a good bond yielding 10% was providing a fat income, and a fat income is a hell of a lot better than a 1% yield on a stock that is in a state of collapse. The concept of value had returned!

In a subtle way, I believe today's stock market could be reflecting the split which I described between the poor and lower middle class Americans—and the upper middle class and the rich. For instance, the NYSE Cumulative Most Active Stock Index (representing big money interest) has been pushing up to new bull market highs, week after week (see chart). Thus, the advance-decline line of most-actives tells us that the big money is enthusiastic and doing fine. But the broad NYSE advance-decline ratio, as noted in the last Letter, has been having trouble getting back to its February 24 peak. It's been pushing and huffing and puffing, but it isn't quite there yet.



Now you can't have prosperity in this or any other nation based on a small segment of the population doing well. Real prosperity is based on the great majority of people feeling good, making money, doing well. And by the same token you can't have prosperity in the stock market based on 10% or 20% of the stocks doing well. That 20% may lead the pack, they may point the way, but a real primary bull market is based on the majority of stocks moving up, and that's the problem the market is dealing with today.

The Averages have been taking their time about coming to a decision. The "line" movements, the sideways action of the Averages, have been going on ever since February. As I wrote many months ago when these line formations started, a line is a structure which may appear after a major rise, and a line may substitute (in basically strong markets) for a correction. All lines imply a situation in which supply and demand are closely in balance. The majority of lines in bull markets eventually break out on the upside, just as most lines in bear markets break to the downside. Because we are now in a bull market, I expect that this series of long lines in the various Averages will ultimately be resolved to the upside.



Despite many important individual stock movements, line structures give the appearance of inactivity. And nothing is so calculated to annoy, bore or discourage the public as does inactivity on Wall Street. Therefore, I would guess that much of the action within thepresent line structures has to do with public selling of stocks and professional accumulation of stocks. But final proof of that will only be forthcoming if the line structures push up and out of their current upper limits.

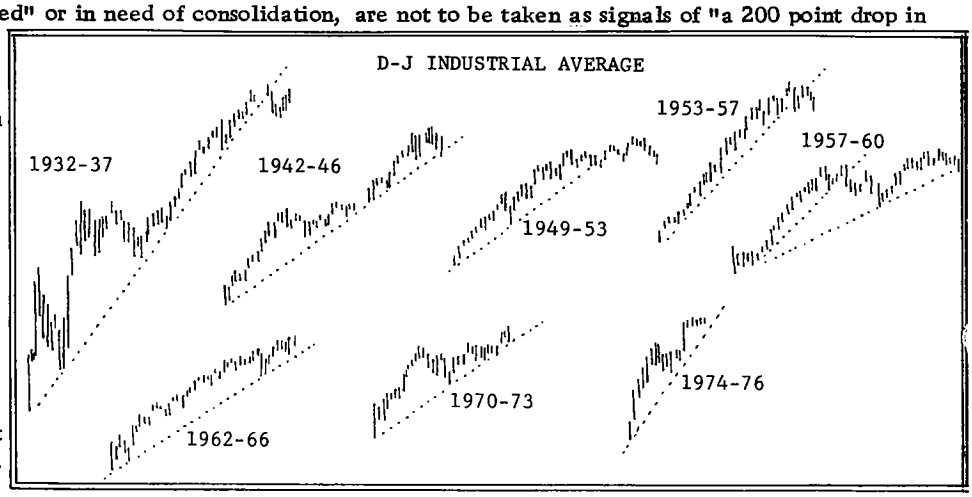
A few Letters ago, I published a chart showing all the major advances in the DJIA since 1932. I showed (on monthly, semi-log charts) that the 1932 to 1937 bull market was built on the steepest angle of ascent in the Dow. But I noted that this bull market has climbed at an even steeper rate of ascent than 1932-37. Conclusion: the market, and more specifically the Dow, had to slow down. And that it has done. Which is healthy, constructive, and fine with this writer.

Now let's review the chart again. I have drawn the trendline on the 1974-76 bull move at the same rate of ascent as the 1932-37 rate. It is clear that the Dow is moving sideways towards the trendline, but it will still take a few months before we even touch the trendline. Therefore, I would consider it perfectly normal and bullish if the Dow continues to back and fill—or even to move back to say 950, prior to the next major bull advance. All of which implies that we need patience, patience and more patience.

Question: Russell, with all your talk of stagflation and higher prices, are you still bullish on the market? Answer: I am. This is a primary bull market, and bull markets ultimately go up, despite any and all problems. Somehow the market seems to see a constructive or at least acceptable solution to all the problems I have mentioned. The market has a talent for looking much further ahead than I can, so I've learned to spend my energy trying to understand what the market is telling me (rather than arguing with the Averages).

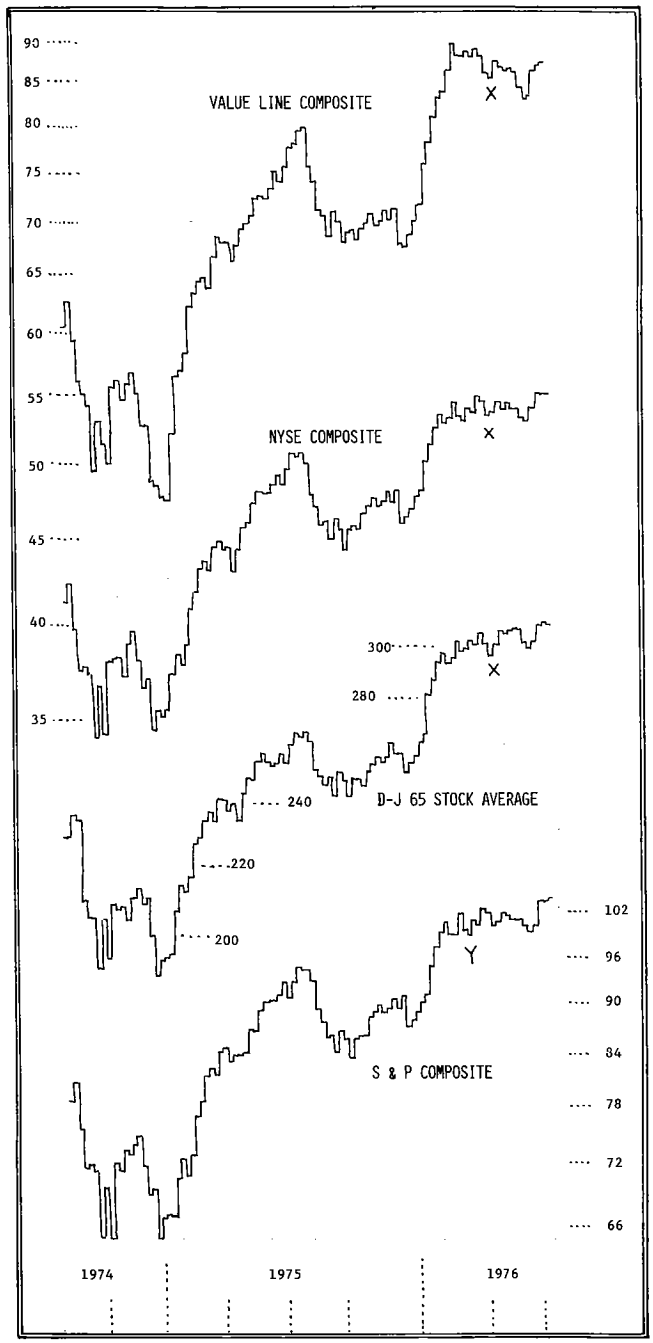
BULL MARKET: When you are talking about a primary bull market you are talking about the big picture. One of the things I constantly warn against is the obsession with picking through the branches and even the leaves, while forsaking the tree. In a primary bull market most of my studies go towards satisfying myself that the bull tide is still in effect. Regardless of what techniques or indicators I use, I always employ them with the thought in mind that this is a bull market and the Averages and indicators are (or are not) acting in a way which I consider to be in harmony with the bull primary force.

I've constantly warned that indicators which provide beautiful danger signals during a bear market may not work too well in a bull market (or they may not work at all). Thus, minor divergences, out-of-gear movements, weakness in the A-D ratio, etc., while they may indicate that the bull market is "tired" or in need of consolidation, are not to be taken as signals of "a 200 point drop in the Dow" or a danger signal that the end is here.



Another point I wish to make is that when you are dealing with the big picture, it often helps to study the big Averages on a weekly basis over an extended span of time. Basic and fundamental as it is, you probably have not seen anything like the page 3 chart anywhere else. What we see here are the four most widely followed Composite Averages charted over the entire span of the current bull market. I have drawn these Averages (weekly Friday closings) on ratio scale so that they can be properly compared as to percent-

age of movement. On ratio scale all movements are shown in percentages so that, for instance, a 16% advance on the Value Line Composite will take up the exact vertical distance on the chart as a 16% advance on the D-J 65.



The Value Line Average is a geometric Average, which is made up of 1650 stocks from the NYSE, the Amex and the over-the-counter market. It is the broadest Average, and many feel it provides the most accurate picture of what American stocks are doing. The NYSE index is made up of all 1544 common stocks on the NYSE and it reflects percentage change in the total market value. The S&P 500 contains the 500 largest Big Board corporations, and it is weighted for capitalization. But it is a good average and tends to follow closely the pattern of the NYSE Composite. The D-J 65 Average is made up of all the stocks in the D-J Industrial, Transportation and Utility Averages. The Dow 65 Average is fairly volatile, and it will often give indication ahead of the other three.

I have studied the price action of these four Composites for many years, and I keep both daily and weekly charts of them. One observation I want to make is that important movements (advances or declines) in the market are always confirmed by all four Averages. In other words, an important downside move is always confirmed by all of these Averages. If it is important, it will show across the board.

For instance, look at the final downward plunge by Value Line and the D-J 65 during late-1974, at the bear market low. This move was not confirmed by either the S&P 500 or the NYSE Composite. That was one of the many reasons why I turned bullish in late-1974. Now examine the powerful swing into 1976. Note that all four Averages bettered their 1975 high on this advance. To me, that helped to identify the rise as a valid bull swing.

Now note the latest action. We see that the recent weakness took the Value Line and the NYSE Composite below their April lows (the April lows are marked "X" on the chart). But the D-J 65 refused to break its April low. And the S&P broke below the April low but held above the March low (March low is marked "Y" on chart). Thus, we did not get downside confirmation of weakness in the four Averages following the minor April, 1976 lows.

Next came the rally to the June 21 highs. Here the NYSE Composite and the S&P 500 hit new bull market highs, but the advance was not confirmed by the D-J 65 or the Value Line Composite. Since then, the various Composites have been backing and filling within their price ranges of the past five months.

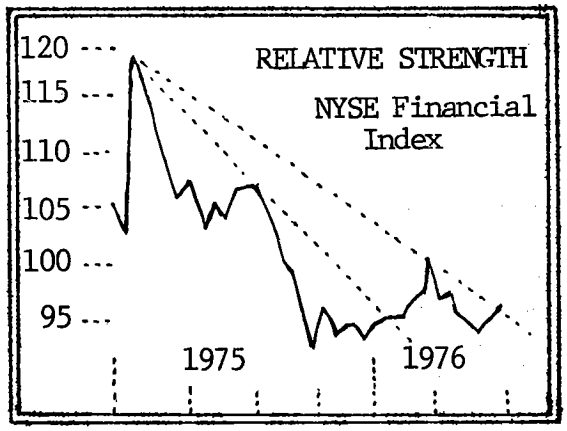
In due time, we will have a broad move which will see uniform and confirming action in all the Composites. That will be the swing which will take the market out of its current sideways "line" range. My own guess is that the swing will be to the upside, that it will be a bull market movement. And I might as well say it one more time, if it's a bull market (and I am convinced that it is), then values are steadily appreciating. And that's another way of saying that in a primary bull market time is on the side of the bulls.

FINANCIALS: I have been writing repeatedly about the NYSE Financial Index, a unique index which contains over 200 NYSE stocks (literally every stock connected with banking and finance on the Big Board). The reason I have been so interested in the Financial Index is this: The whole liquidity-monetary-interest rate syndrome has been hanging over investors' heads like a cloud ever since this bull market started.

In the backs of our minds loom questions like this: "Will the banks make it, will higher interest rates choke off the bull market, will liquidity build up enough to support a boom, will corporate and government financing kill the bond market?" My feeling is (and has been all along) that in a primary bull market, everything "somehow seems to work out all right." I might add, that the converse is that during a bear market everything that can go wrong somehow does go wrong (look at the gold stock picture now).

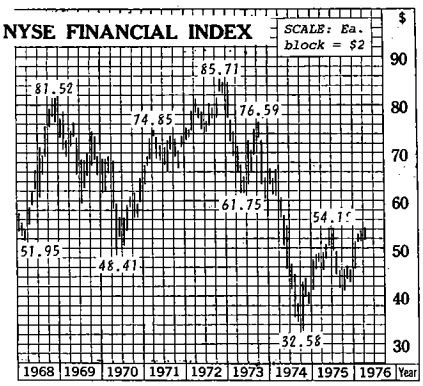
But aside from my optimism based on the fact that we are in a primary bull market, we have the broad NYSE Financial Index to

watch. Note on the lower chart that the Financial Index hit a 1975 peak of 54.19. The Index then dropped back into the low 40's. Next, the Index rallied up to a high of 54.30 on April 6, 1976. Thus, we have a "double top" on the Financials in the 54.30 range.



My feeling is that the Financial Index is headed higher. I would consider a rally above 54.30 (to a new bull market high) to be extremely bullish for the market as a whole. Such a new high on the Financials would mean to me that the market saw the clouds parting on the whole money front, from Banks to Savings and Loans, from Consumer Credit to Insurance.

What really interests me now is the top chart which shows the Financial Index on a relative strength basis (compared to the NYSE Composite). In early 1976 the Financials pushed above the steep descending relative strength line. At the end of June the second shallower descending trendline was bettered. The Financials are now beginning to act better than the market as a whole. If this strength continues (and relative strength trends are usually very persistent) it should become obvious in the price of the whole spectrum of financially oriented stocks. I cannot imagine that such action would not be taken bullishly by informed investors. So let's watch that 54.30 1976 peak on the Financial Index. Bettering it would be very bullish for the market. (Monthly chart of the Financial Index courtesy of Horsey, Salisbury, MD 21801).



SUNDRY THOUGHTS: I don't know of a better way to accumulate assets than by purchasing high yielding bonds or bond funds, then letting the interest compound, and reinvesting that interest in additional high yielding bond funds. But there is a catch to this procedure. It's sure, it's uninteresting, but it's downright boring. In order to follow the compounding path to making money, you have to (1) like to make money, and (2) be able to follow a plan, and (3) be willing to get your thrills and excitement on the golf course, fishing, flying a plane or making love.

The fact is that good debt instruments are in a bargain range now. High grade preferred stocks, good bonds, municipals, closed-end bond funds, open-end bond funds, all of these are providing yields in the 7-10% range. It's true that if you collect your interest and dividends you'll have to pay the taxes (unless you are buying tax-exempt bonds), but there are the annuity plans, the Keough plan, and there are corporate pension and profit-sharing plans. All of these avoid current taxes.

For my average subscribers, I would suggest that around half of all liquid assets go into debt instruments at today's high yields. Get on the compounding path. I've said this a number of times before, but I want to put it down in writing again. It's the surest and most boring way of accumulating money that I know of. I recommend it highly.

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Speaking of debt instruments, the trend is now towards Federal Government guarantees on state and local bond issues—rather than tax-free status. Thus, we may be seeing the virtual end of the municipal tax-free bond. If so, muni's will be going to premiums shortly, and I hereby suggest that all subscribers who wish to purchase muni bonds (tax free) move rapidly. Some of the larger Wall Street houses offer muni bond funds, which offer the safety of diversification (Hutton, Merrill Lynch, Nuveen).

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The public and most investors are always concerned with the recent past. In fact, that's the tragic side of stock market history. For instance, the terrible "Panic of 1907" was caused by a credit crisis. This was instrumental in bringing about the concept of the Federal Reserve System (1913), which was supposed to eliminate that danger. But the cave-in of 1921 was the result of another factor, a simple collapse in industrial production. After that, investors watched credit and the production figures, but in 1929 the market crashed when the speculative edifice of Wall Street fell of its own weight. The Securities Exchange Act of 1934 remedied the speculative problem.

In 1937, while investors watched credit, speculation and production, the market and the economy smashed due to (or set off by) a commodity collapse. It took World War II to pull the nation out of the late-30's slump. In 1948-49 the market fell away due to the public's insistence that the "great post-War depression" was on its way. The depression never materialized. The 1966-74 bear market was a normal aftermath of 17 years of every kind of excess from idiotic banking to over-speculation to unsustainable inflation. Which brings us to today.

And today, as in 1907, my thesis still stands. I claim that we are always looking at "yesterday's problems" even while the new problems of tomorrow loom in front of our faces. Thus, the great fear now is that inflation and high interest rates will suddenly reappear, as per the early 1970's. And appear they might, but my guess is that investors and the public are still looking at yesterday. "Will inflation and high interest rates bust this market again?" you ask. And I answer, "Maybe, but I'm not convinced that we've all grown so wise that we're finally looking in the right direction. If I had to guess, I'd say that the next major bear market (whenever it starts) will come from a new direction, a direction few people are aware of at this time.

And just as we tend to be obsessed with yesterday in the world of events, investors are obsessed with yesterday's market strategies and techniques. Yale Hirsch in his latest report (Smart Money, 6 Deer Trail, Old Tappan, NJ 07675), notes that "Wall Street pundits are like generals who fight the last war over again. In 1959, they favored the basic industries. In 1972, they were all for glamour growth stocks. Today they are conditioned by 10 years of a gyrating market, and they have developed a trading mentality."

I couldn't agree more. The hardest thing in the world to do is buy right when a bull market begins (and many of my subscribers did), hold your stocks throughout the bull market (and many are doing this), then sell out in the third or final phase, as the public comes in heaviest, at a time when everybody and his brother is "cleaning up" on Wall Street.

Personally, I have nothing against lightening positions in a bull market, then reinstating positions after a correction. I feel particularly good about such procedure at the end of the second phase of a bull market, because the wind-up of the second phase is so often accompanied by a very severe secondary reaction.

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I have often said that a primary bull market tends to bail one out of all mistakes. Before a bull market is over, the cyclicals, the resource stocks, the glamours, the utilities, the low-priced issues and the cats-and-dogs will all have their speculative fling. They will have their blow-offs individually, with the group or with the market as a whole—but they will have them.

At this juncture I want to offer a few observations about the current market. (1) I don't think we've seen the speculation yet. We've seen some speculation in some specific areas, but in general this has been a sober affair, with stocks selling on the basis of value. That's second phase action.

(2) The consensus is that this bull market is moving towards a final top later this year or maybe in early 1977. I am not at all convinced. My own guess is that the bull market is going to last longer and go higher than most of us now believe.

(3) There is a general feeling that when the public finally turns around and decides to buy this market, it's going to be all over, kaput. I don't believe that either. In a bull market, there comes a time when everybody is buying and when everybody who is buying is right. That period can last for quite a few months. But one thing is sure, we're not there yet, not by a long shot.

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Think about these extraordinary figures. The mutual fund public is selling about $300 million more in funds than they are buying each month. The odd lot public is selling about $120 million more in odd lots than they are buying each month. Brother, that's $420 million per month at the exit gates or $100 million a week! With the total market value of the markets at a new peak (the Wilshire 5000 Index of all Exchanges was at a new high of $880 billion last week) we know someone has to be buying all those millions of dollars worth of stock that the odd lot and mutual fund public is dumping. That "someone" is the smart money, the investment money. And they are going to be right about this primary bull market.

Before the bull has breathed its last, we're going to see the public come back and re-enter the market. They're going to buy back all those shares that they're selling today. I don't know how or when the public is going to buy the stock, but I know why they're going to buy it. They're going to buy the stock because the newspapers and the magazines and the TV news and the radio news is all going to be bullish again. And it is well to remember that informed investors distribute under the guise of good news. Good news, public enthusiasm, high volume, all go to make good markets—and informed money loves a good market to sell into.

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In Letter 667 ("Survival") I stated that I was less and less intrigued by the whole concept of escape to a foreign haven (or even of keeping assets in a foreign bank). Now comes New York Magazine (July 5 issue) with a lead-off article entitled, "The Last Time I Saw Paris, It Was in New York." The gist of the piece is that (ironically) while the white middle class is pouring out of NYC, the world's rich are pouring in. The reasons are the ones I have already recited, Europe may not be going Communist, but it is communizing. In Britain, the talk is of a wealth tax (assuming there is any wealth left in coming years). Italy is increasingly shaky, France is about to institute its first capital gains tax, Germany is getting tough with business, and even Switzerland is toying with "changing the rules" (secrecy rules, of course). In the New World, Canada is practically socialist, Mexico has a revolutionary feel about it (I hear from friends on the police force that the big border swaperoo here is US guns for Mexican dope). But the fact is that foreign money is pouring into the US, to the tune of billions of dollars. Increasingly, the US is the world's last real haven!

GOLD-SILVER-COMMODITIES: I've been getting discouraged by people calling to tell me that they still have "500 shares of ASA" or "1000 shares of West Driefontein" and now they're worried sick. I ask them why they held these stocks all the way down, and I can't seem to get any kind of coherent answer. One man told me that he figured his gold shares were "just a small part of his total assets, and he just didn't pay attention to them when they drifted down." I asked him why he was calling me now, and he said, "Well, now it's beginning to really scare me."

Another woman called to say that she was frantic. Her husband died a year ago, leaving her a carload of S. African gold shares, and now her large inheritance has dropped 75%. I asked her why she has held them, and she answered that "her husband's advisor had insisted that she hold on." I told her that the first thing to do was "get rid of your advisor, he's incompetent."

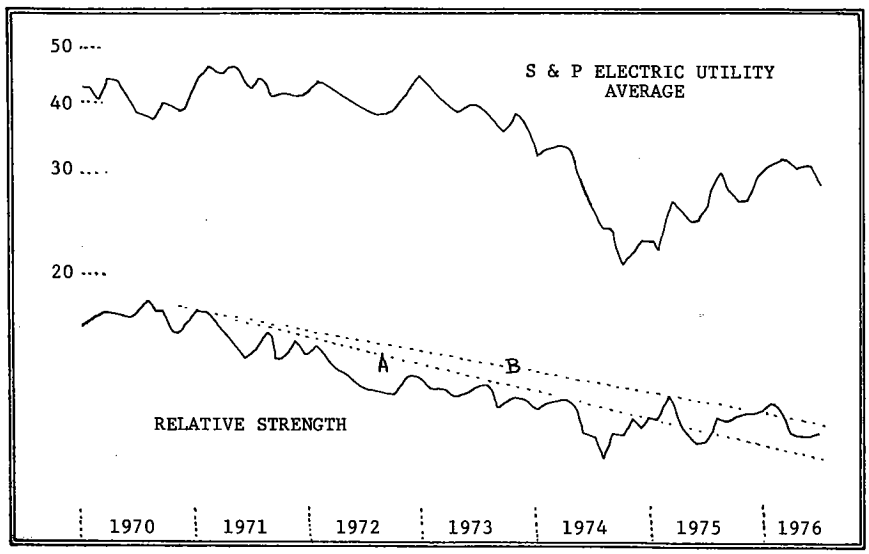
One man I know well has refused to sell any of his large holdings of S. African gold shares, but he's been selling ASA and Homestake short "against the box" (i.e., against his own holding of Homestake and ASA). I know why he's doing it. He simply can't admit that he's been wrong. And of course, if he actually sells his gold shares he will be admitting to himself that he rode a bear market all the way down. "If you sell short, why wouldn't you sell out?" I asked. He mumbled something I couldn't understand, but in his heart I know that he's hoping that the gold shares will turn around tomorrow and roar skyward. Hope springs eternal in the heart of the speculator who lives by arrogance, stubbornness, and incorrect market procedure.

The price of gold appears to me to be under manipulation. I could state a number of reasons why I believe this is true, but the obvious one is that various large interests want it low. My guess is that gold is under long-term accumulation, and I'll repeat that I don't think there is any great risk buying small or "survival quantities" here. But I wouldn't take a big position on gold (or anything else) unless it was in an established bull trend. Therefore, stick to small positions in modern gold coins such as kruggerrands or coronas.

Silver is in a different story. Silver finally leaped over the $5 barrier this week. The white metal is now well out of its huge triangle formation, and it is acting like the rest of the commodity market. It's moving higher. The generally accepted thesis is that silver is moving into a supply shortage position, and I have read expert testimony seeking to document that idea. I won't argue with the silver experts, and so far the market is saying they're right.

The commodities are also popping. Crops around the world are being mangled by the fantastic drought conditions (California is having its worst dry period in 125 years). This is coming on top of the recent forecast of grain shortages across the face of Europe and Asia. It's too early to tell whether the commodity move is for real or just a case of speculators' nerves, because plantings for '76 (despite droughts) have been huge. At any rate, the metals are moving up with the grains, and all this is bringing on fears of new inflation. But, cynic that I am, I'm not convinced. I want to see more. Conditions today are very different from the inflationary conditions of the early 1970's, and the global speculative jag has subsided.

STOCKS: The Utility Average was the first to top out in the 1966-74 bear market. Almost everything that can go wrong with an industry went wrong with the Utilities, and this is especially true of the Electric Utility industry. The relative strength (RS) of the Utilities has been almost steadily down since 1965. This means, of course, that on a trend basis the Utilities have been acting worse than the general market for over twelve years.



I have shown some of this action on the accompanying monthly chart. But I want to draw attention to what I think could be a dramatic new development. The RS line for Electric Utilities actually hit its low in mid-1974. In early 1975 the RS line labeled "A" on the chart was bettered as the Utilities rallied. A period of digestion occurred next, followed by a new rise which saw a second, steeper RS line ("B" on chart) bettered.

Next, came the 1976 consolidation, but on my weekly RS chart (not shown) the RS in Electric Utilities is beginning to turn up again. If the RS on this longer monthly chart can establish itself firmly above trendline B, I believe we will have a very bullish situation in the Electric Utility group of stocks. Action over the past few days suggests to me that within a few weeks the Electric Utility Average is going to push above line "B". Therefore, I am directing subscribers' attentions to this most interesting situation.

In the last Letter I mentioned some of the "cheap" options which are available in such utility stocks as American Electric, Virginia Electric, Southern Co. I am now saying that I feel the Electric Utility shares can be purchased as values, as high-yielding investments, as stocks with good appreciation prospects. Adding to the attractiveness of the Electric Utility shares is the fact that they have been declining in RS for a dozen years, which means that they are currently out of favor and fundamentally "cheap."

A few of the better Utilities (all A-rated with long dividend records, and high current yields) are Arizona Public Service, Carolina Power & Light, Gulf States Utilities, Illinois Power, Pacific Gas & Electric, San Diego G&E, Utah Power & Light. This is just a very fractional list. Talk to your broker for a much more complete listing.

NOTE: All the chart albums of the D-J Averages have been sent out, and purchasers should receive them very shortly. These are the albums containing the D-J Industrials, Transports, Utility and Bond Averages (daily) going back "all the way," which is back to 1885 (one page for each year). Volume is included on the charts, as is historical data and comments. Price is $49 ($52 for Californians).

LATE MARKET NOTES: The Dow Industrials are still acting "spooky," but the Transports are holding firm and the Utilities are now acting superbly. I am not impressed by the downside action when it occurs. When this market rallies, everything goes up, when it declines the declines are spotty and selective. That's why my Primary Trend Index keeps going to new highs (which is constructive).

Next Mailing: July 21st